

QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

July 1, 2009

Volume 2 Issue 125

Market Overview

Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> or Letters from listed dates for details)

| Study Date | Description | Time span | Bias | Avg Max Move | Avg MM + 1/2 Std Dev |
|---------------------------|-----------------------------------|------------|---------|--------------|----------------------|
| Active | | | | | |
| July 1, 2009 | 1st day of month | 1 day | Bullish | | |
| June 30, 2009 | High close 10 on low vol 10 | 1-3 days | Bearish | -1.80% | -2.70% |
| June 29, 2009 | Low range and vol above 10ma | 1-15 days | Bearish | -4.40% | -6.90% |
| June 26, 2009 | 2 Days 7:3 up issues - no 10 high | 1-8 days | Bearish | | |
| Active - Long Term | | | | | |
| June 26, 2009 | VIX:VXV drops below 0.9 | 2-5 months | Bearish | | |
| June 22, 2009 | VIX:VXV hits 100-day low | 1-20 days | Bearish | -3.80% | -5.50% |
| June 11, 2009 | 4-day tight range above 10ma | 1-20 days | Bullish | 4.00% | 4.80% |
| June 10, 2009 | Nasdaq/NYSE Volume High | 1-20 days | Bearish | | |
| June 1, 2009 | Nasdaq Relative Strength Leading | | Bullish | | |
| April 20, 2009 | Low Nasdaq Weekly Vol Spyx | 1-10 weeks | Bearish | | |
| Dropped Tonight | | | | | |
| June 25, 2009 | 2 Days Up in Chop | 1-4 days | Bearish | | |
| June 24, 2009 | Weak breadth on bounce | 1-5 days | Bearish | -4.20% | -5.10% |

If the avg max move is achieved the study will appear in **bold and brown**. If the avg + 1/2 std deviation is achieved, it will appear in *bold italic blue* and no longer be active.

Short-term Outlook (1-5 days) – updated 7/1 – slightly bearish

The first half of the year ended on a down note for the market. A sharp drop in the morning did see a bit of a rebound late afternoon, but the major indices all finished lower on the day. The Nasdaq was down about ½% and the SPX almost 0.9%. Breadth was negative. The NYSE Up Issues % was 43% and the Up Volume % only 29%. Volume came in higher than Monday and about average overall.

There was very little of interest that triggered today. It did mark the 5th higher high in a row. As I mentioned in the intraday email 5 higher highs often leads to choppy conditions but doesn't provide a substantial edge either way. Below is a copy of the test I sent out in the intraday alert that looks at 5 higher highs that fail to make a 20-day high.

| 5 Higher highs and no 20-day high. Buy on close. Sell X days later. \$100k/trade 1978 - present. | | | | | | | | | | |
|---|-----------------|-------------------|---------------------|--------------------|-------------------|------------------------|-----------------------|--------------------|-------------------|----------------|
| X Days | All: Net Profit | All: Total Trades | All: Winning Trades | All: Losing Trades | All: % Profitable | All: Avg Winning Trade | All: Avg Losing Trade | All: WinLoss Ratio | All: ProfitFactor | All: Avg Trade |
| 5 | -18,268.86 | 54 | 23 | 31 | 42.59 | 1,522.48 | -1,718.90 | 0.89 | 0.66 | -338.31 |
| 4 | -17,515.11 | 54 | 24 | 30 | 44.44 | 1,075.64 | -1,444.35 | 0.74 | 0.60 | -324.35 |
| 3 | -17,973.21 | 54 | 23 | 31 | 42.59 | 1,015.50 | -1,333.22 | 0.76 | 0.57 | -332.84 |
| 2 | -5,552.14 | 54 | 23 | 31 | 42.59 | 987.17 | -911.52 | 1.08 | 0.80 | -102.82 |
| 1 | -5,506.22 | 54 | 22 | 32 | 40.74 | 551.62 | -551.31 | 1.00 | 0.69 | -101.97 |

As you can see, the downside edge is very mild over the next few days. I also looked at what happened when the 5th higher high coincided with a down close. In this case the downside edge was eliminated and you were left with basically a breakeven situation.

I also mentioned in the intraday update that 1st day of month seasonality could have a positive impact on Wednesday's trading. I'll be posting more detail on 1st day of month on the blog. July has been quite good. Below are the results for July over the last 22 years:

| 1st trading day of July. \$100k/trade. 1987-present. | | | |
|---|-------------|--------------------------|--------------|
| TradeStation Performance Summary | | | Collapse ^ |
| All Trades | | | |
| Total Net Profit | \$8,745.86 | Profit Factor | 2.95 |
| Gross Profit | \$13,225.78 | Gross Loss | (\$4,479.92) |
| Total Number of Trades | 22 | Percent Profitable | 77.27% |
| Winning Trades | 17 | Losing Trades | 5 |
| Even Trades | 0 | | |
| Avg. Trade Net Profit | \$397.54 | Ratio Avg. Win:Avg. Loss | 0.87 |
| Avg. Winning Trade | \$777.99 | Avg. Losing Trade | (\$895.98) |
| Largest Winning Trade | \$1,818.44 | Largest Losing Trade | (\$2,138.17) |

Seasonality numbers can be fickle, though. They aren't anything I would usually base a trade on without additional evidence.

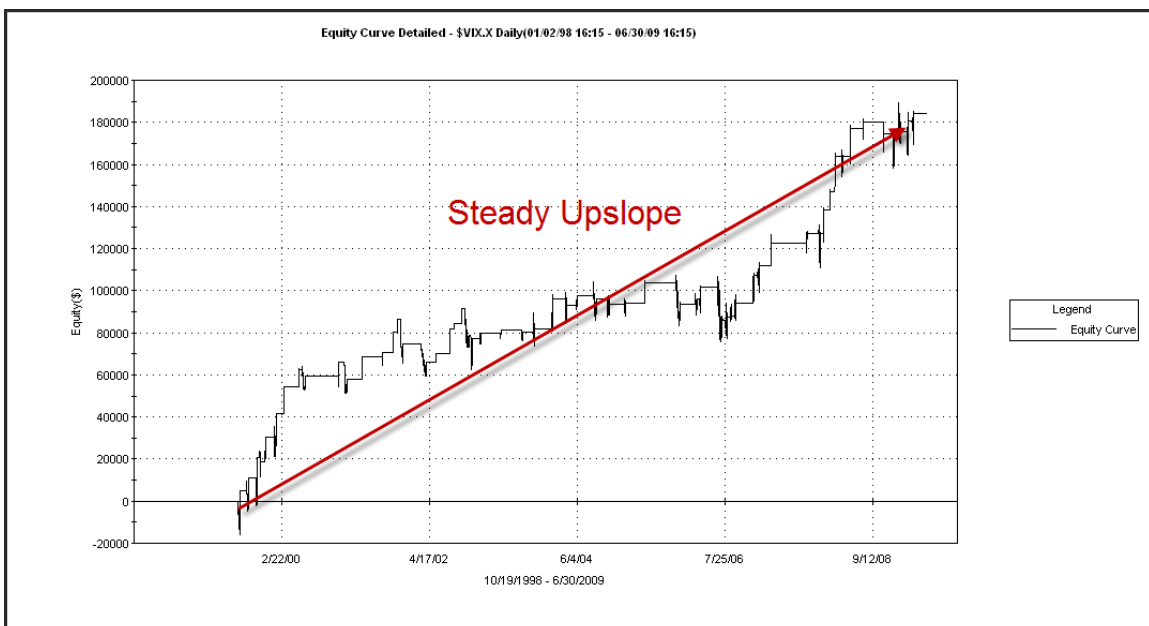
The VIX moved from it stretched position to cross back above the lower 10% band of the 10-day moving average. A little over a year ago on the blog I discussed a strategy in which the SPX could be sold short on a cross up through the VIX 10% lower band. The trade would be held until the VIX found its way across the 10-day moving average. Results discussed then were pretty good (and right near the peak). This "system" has taken some hits recently, though. Below is an equity curve.



It looked to be gaining traction again about a year ago, but soon dipped back down. At this point it hasn't made any progress for about 7 years. Again – not something I want to base a trade on.

But what if instead of shorting the SPX, you bought the VIX? We've discussed the possibility of using VXX as a proxy for the VIX. The average trade is less than 7 trading days so VXX erosion shouldn't be a big factor. Since VXX history is so short I instead used the VIX to run the test. In this case we are buying when the VIX moves up through its lower 10% band and selling on a cross above the 10ma.

41 of 57 trades (72%) would have closed profitable. As you can see the equity graph has a much steadier slope.



Aggressive traders looking to take advantage of the VIX situation could consider buying VXX.

Tonight's **Aggregator** chart is below:



The Aggregator chart still shows a bearish inclination. The green Aggregator line has barely budged from yesterday as net expectations from the studies remain negative. The black Differential line did move up quite a bit as Thursday's big rally was dropped from the calculation and the SPX fell today. Still, it's going to take more selling tomorrow to move the Differential line back above zero.

At this point I plan to hold on to my $\frac{1}{2}$ SPY position and not add any more. I may look to trail a stop tomorrow depending on market action. If the SPX closes down again I will likely take at least $\frac{1}{2}$ the current position off and perhaps the whole thing.

Intermediate-term Outlook (2 weeks – 2 months)– updated 6/29 – neutral (near turning bearish)

There is still a bit of a mix among the intermediate-term indicators. From a price standpoint the SPX seems to be stuck in a consolidation following a rally (March – May). It really hasn't gone hardly anywhere for about a month and a half. It's dangerous to get too bearish before you actually see price break down. The 875-880 area appears important to hold.

The Nasdaq/NYSE volume indicator continues to suggest an unhealthy amount of interest in Nasdaq stocks. I noted this indicator in a study a few weeks ago (listed in the summary at the top of the Letter). It isn't one of my favorite indicators, though, because much of the suggestion from the indicators come from on time period – the 2000-2003 bear market.

Friday's nightly Subscriber Letter discussed the fact that the VIX:VXV Ratio had fallen below 0.9. This was a level that has historically suggested bearish consequences for the intermediate-term. I discussed a system first published in the 8/25/08 Letter that looked at shorting the market when the ratio fell below 0.9 and then covering on a move back over 1. Though the system required patience and the trades averaged about 2.5 months, the results were solidly bearish. All the trades are listed below:

| VIX:VXV Ratio crosses below 0.9. Short S&P 500 on close. Cover when ratio crosses above 1. \$100k/trade 8/2002-present. | | | | |
|--|--------|------------|----------|--------------------|
| Date/Time | Signal | Price | % Profit | Run-up DrawDown |
| 01/02/03 | Short | \$909.03 | 5.24% | \$5,425.20 |
| 01/24/03 | Cover | \$861.40 | | (\$2,862.20) |
| 08/12/03 | Short | \$990.35 | (5.38%) | \$999.00 |
| 11/17/03 | Cover | \$1,043.63 | | (\$7,330.00) |
| 01/16/04 | Short | \$1,139.82 | 2.90% | \$2,953.65 |
| 03/11/04 | Cover | \$1,106.79 | | (\$2,036.67) |
| 03/25/04 | Short | \$1,109.28 | 4.15% | \$4,234.50 |
| 08/12/04 | Cover | \$1,063.23 | | (\$3,716.10) |
| 08/25/04 | Short | \$1,104.96 | (2.28%) | \$1,329.30 |
| 10/29/04 | Cover | \$1,130.20 | | (\$3,338.10) |
| 12/09/04 | Short | \$1,189.24 | 3.85% | \$3,974.88 |
| 04/15/05 | Cover | \$1,143.43 | | (\$3,349.08) |
| 06/02/05 | Short | \$1,204.29 | 2.28% | \$2,995.47 |
| 10/13/05 | Cover | \$1,176.84 | | (\$3,450.31) |
| 11/25/05 | Short | \$1,268.25 | (2.91%) | \$1,755.78 |
| 05/01/06 | Cover | \$1,305.19 | | (\$3,892.98) |
| 07/03/06 | Short | \$1,280.19 | 2.96% | \$3,023.28 |
| 07/13/06 | Cover | \$1,242.28 | | \$0.00 |
| 08/16/06 | Short | \$1,295.43 | (8.01%) | \$457.38 |
| 02/27/07 | Cover | \$1,399.14 | | (\$12,792.78) |
| 06/19/07 | Short | \$1,533.70 | 2.66% | \$2,805.40 |
| 06/26/07 | Cover | \$1,492.89 | | (\$235.30) |
| 10/09/07 | Short | \$1,565.15 | 3.62% | \$4,762.17 |
| 11/01/07 | Cover | \$1,508.45 | | (\$689.22) |
| 12/20/07 | Short | \$1,460.12 | 3.32% | \$3,327.24 |
| 01/04/08 | Cover | \$1,411.62 | | (\$2,633.64) |
| 05/12/08 | Short | \$1,403.58 | 8.80% | \$9,342.18 |
| 06/30/08 | Cover | \$1,280.00 | | (\$2,602.86) |
| 08/21/08 | Short | \$1,277.71 | 4.16% | \$4,717.44 |
| 09/09/08 | Cover | \$1,224.54 | | (\$1,975.74) |
| 06/25/09 | Short | \$920.26 | n/a | \$0.00 |
| open | n/a | \$920.26 | | \$0.00 |

I then went on to examine how the VIX had performed over the same period. Below is an excerpt from Friday's Letter that discusses this:

I also decided to check performance if the same system was run against the VIX instead of the SPX. Obviously these trades could not have taken place since the VIX is not a traded index but it does let you know how the VIX performed. Note these are long trade instead of short.

VIX:VXV Ratio crosses below 0.9. Buy VIX on close. Sell when ratio crosses above 1. \$100k/trade 8/2002-present.

| Date/Time | Signal | Price | % Profit | Run-up DrawDown |
|-----------|--------|---------|----------|--------------------|
| 01/02/03 | Buy | \$25.39 | 24.10% | \$24,100.56 |
| 01/24/03 | Sell | \$31.51 | | (\$4,489.32) |
| 08/12/03 | Buy | \$17.94 | 3.68% | \$29,653.68 |
| 11/17/03 | Sell | \$18.60 | | (\$11,984.10) |
| 01/16/04 | Buy | \$15.00 | 37.80% | \$37,929.54 |
| 03/11/04 | Sell | \$20.67 | | (\$7,999.20) |
| 03/25/04 | Buy | \$17.88 | 6.71% | \$14,371.44 |
| 08/12/04 | Sell | \$19.08 | | (\$27,904.08) |
| 08/25/04 | Buy | \$14.98 | 8.61% | \$12,615.75 |
| 10/29/04 | Sell | \$16.27 | | (\$15,886.50) |
| 12/09/04 | Buy | \$12.88 | 37.73% | \$40,134.71 |
| 04/15/05 | Sell | \$17.74 | | (\$15,370.74) |
| 06/02/05 | Buy | \$11.84 | 39.10% | \$45,180.75 |
| 10/13/05 | Sell | \$16.47 | | (\$16,552.20) |
| 11/25/05 | Buy | \$10.88 | 15.26% | \$33,822.88 |
| 05/01/06 | Sell | \$12.54 | | (\$6,709.43) |
| 07/03/06 | Buy | \$13.05 | 36.32% | \$36,624.36 |
| 07/13/06 | Sell | \$17.79 | | (\$0.00) |
| 08/16/06 | Buy | \$12.41 | 47.54% | \$53,182.80 |
| 02/27/07 | Sell | \$18.31 | | (\$24,335.16) |
| 06/19/07 | Buy | \$12.85 | 47.00% | \$47,003.28 |
| 06/26/07 | Sell | \$18.89 | | (\$778.20) |
| 10/09/07 | Buy | \$16.12 | 43.98% | \$49,810.09 |
| 11/01/07 | Sell | \$23.21 | | (\$248.12) |
| 12/20/07 | Buy | \$20.58 | 16.33% | \$18,075.48 |
| 01/04/08 | Sell | \$23.94 | | (\$11,175.70) |
| 05/12/08 | Buy | \$17.79 | 34.63% | \$38,054.17 |
| 06/30/08 | Sell | \$23.95 | | (\$11,073.37) |
| 08/21/08 | Buy | \$19.82 | 28.51% | \$29,563.70 |
| 09/09/08 | Sell | \$25.47 | | (\$5,953.10) |
| 06/25/09 | Buy | \$26.36 | n/a | \$0.00 |
| open | n/a | \$26.36 | | \$0.00 |

Only one to pick bottom

Highest entry price

In every case the VIX was trading higher when the ratio crossed back above 1. There was only 1 instance out of the 15 where there wasn't at least some additional pullback. I

also noted on the table above that this is the highest the VIX has ever traded when the VIX:VXX Ratio initially dropped below 20. Fifteen for fifteen winners is fairly impressive and would seem worthy of a trade, especially considering some of the % returns of several of the trades above. The AVERAGE trade saw the VIX gain 28.5%.

While the VIX isn't tradable, options, futures, or the fairly new VXX etf are all possibilities.

I'm a little concerned that basis risk in the futures along with fund expenses may cause erosion in the VXX. My concern seems unfounded when you look at the performance since its inception at the end of January. Over that time the VIX has dropped 41% and the VXX only 32%. Still, while I think it could be worth a trade, I'm going to study the VXX a bit more tomorrow and perhaps ask some people with a better understanding of the complexities than me.

On Friday I shared the study and posed the following question to [Bill Luby of the VIX and More site](#) and [Adam Warner of the Daily Options Report](#).

“Do you believe VXX could be an appropriate intermediate-term trading vehicle, or does the structure of it suggest it is likely to erode over time (like a slow – motion Direxion triple ETF)?”

Their input was enlightening.

Bill did a nice job of explaining how the VXX worked and why it could suffer some erosion over time.

With the leveraged ETFs, the price decay is a function of volatility (and partly leverage). With VXX, things are a little different because they do daily rebalancing. The issue is one of term structure. In a contango (normal) environment, the VIX futures prices tend to slope upward the farther you go out in time to reflect greater uncertainty. When that happens, each day the VXX rebalances it sells 1/30 of the front month position and replaces it by adding 1/30 to the second month position at a higher price.

Right now that difference is about 75 cents, so we are talking something on the order of 2-3 cents per day ($1/30 * 0.75$) or maybe 50 cents per trading month.

Got it? So in a contango (normal) environment the VXX will likely see a small amount of erosion on a daily basis. Bill then goes on to say...

Of course the VIX is not always in contango. Sometimes the term structure is flat and sometimes it is in backwardation where the front month is more expensive than the back month (especially after a VIX spike). In these instances, the ETF would be making a profit in its daily roll/rebalance trade, as it would be selling the more expensive month (or at least 1/30 of that position) and replacing it with a cheaper month.

VIX futures were regularly in backwardation following the launch of VXX. Only recently has the term structure flattened out and started to go back to contango.

Adam also noted the VXX should see some erosion in a contango environment. He had some interesting thoughts about the current holiday schedule as well:

I'm a little skeptical of VIX/VXV around a holiday. VIX should act weak when a significant chunk of the 30 day period is early summer and pre-holiday blahs. It's 10 calendar days right now until July 6th. SPX traders will lower their bids ahead of anticipated slow trading stretches (remember real options have real time decay you need to offset). So it's overwhelmingly likely VIX will be higher in 10 days than it is now and the VIX/VXV ratio will increase as VXV will not lift as much (10 days decay is not as meaningful in a 90 day option).

In normal circumstances, VXX will track about 40-50% of the VIX move, but will it track it that well now? VXX represents a 30 day (hypothetical) VIX future. A VIX future itself just takes a snapshot of where the VIX will be on expiration day. A holiday between now and then has no impact. VIX July's as I type are about 29, a 2+ premium to the VIX. So you'd first have to make that up before profiting on the VIX.

Now here's the kicker though. I show July as the worst cycle of the year in terms of average and median VIX readings. But if I divide it into the first half of cycle and 2nd half (2nd half always just the last 2 weeks, so if it's a 5 week cycle the first 3 weeks are defined as "half") it almost always lifts in the 2nd half. Which makes perfect sense given the holiday in the middle and then earnings season kicking in at the end.

So you're going to see the VIX trough pretty soon and then lift. Will the VXX lift with it? That I'm not as sure of.

So the current calendar could take some of the edge off a possible VXX trade, since there is a chance it won't track the VIX as closely as usual.

They sum up by stating the following:.

Bill:

The bottom line is that the idea of slow-motion time decay is probably appropriate. Unlike leveraged ETFs, however, where absolute volatility (and direction) determine the rate of decay, for VXX it is the term structure of the VIX futures -- or the relative volatility if you will.

Adam:

If the next month out has a premium to the nearer one, seems like they'll dribble a modest amount away each day. That being said, it's not crude oil here, premiums are often very modest if at all, and the roll should be perpetual and not a one-off deal like in crude.

Long story short...I don't think there's a major ETN structural problem in using VXX.

Now in addition to VXX, there is also a longer-dated volatility ETF (similar to VXV in the VIX:VXV ratio). That ETF is VXZ. It struck me that perhaps one way to offset the contango rolling risk in VXX might be to short VXZ at the same time. Bill informed me that he didn't believe you were allowed to short either of these. I called my broker to see if they were shortable and was told "not today". This does limit their usefulness quite a bit since they can really only be used 1) as a hedge or 2) as a bet on an increase in volatility. There's no way to bet on a decrease in volatility using these proxies.

I'm not going to track any official trade ideas based on VXX at the moment. I have put on a very small position myself for tracking purposes and may discuss any observations I have here after completion of the trade.

It's rare I discuss anyone else's work in the Subscriber Letter but both Bill and Adam really know their stuff. I encourage subscribers to check out their sites and should also let you know they are going to be publishing books. I'd be surprised if their books weren't both filled with nuggets such as those they provided above.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Triggers

none

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 0

Sector CBI Breakdown (% of stocks with active catapult triggers within each sector.)

| Index | ETF | CBI % | Index | ETF | CBI % |
|----------------------------|------------|--------------|--------------------------|------------|--------------|
| DJ US Broker Dealers | IAI | 0.00 | DJ US Energy | IYE | 0.00 |
| DJ US Insurance Index | IAK | 1.56 | DJ US Financial | IYF | 0.37 |
| DJ US Regional Banks | IAT | 0.00 | DJ US Financial Services | IYG | 3.13 |
| DJ US Utilities | IDU | 0.00 | DJ US Healthcare | IYH | 0.00 |
| DJ US Oil&Gas Expl & Prod | IEO | 1.64 | DJ US Industrial Sector | IYJ | 1.14 |
| DJ US Oil Equip & Svcs | IEZ | 2.13 | DJ US Consumer Goods | IYK | 0.00 |
| DJ US Pharmaceuticals | IHE | 0.00 | DJ US Basic Materials | IYM | 0.00 |
| DJ US Healthcare Providers | IHF | 0.00 | DJ US Real Estate | IYR | 0.00 |
| DJ US Medical Devices | IHI | 0.00 | DJ US Transportation | IYT | 0.00 |
| DJ US Aerospace & Defense | ITA | 2.94 | DJ US Technology Sector | IYW | 0.54 |
| DJ US Home Construction | ITB | 0.00 | DJ US Telecommunications | IYZ | 0.00 |
| DJ US Consumer Svcs | IYC | 0.96 | Nasdaq 100 | QQQQ | 0.00 |

Additional New Trade Ideas

A full listing of system triggers can be found at the [system triggers page](#) each night. I will cherry pick some of my favorite setups from the S&P 100 and ETF lists along with occasional other trade ideas to track below.

None tonight. – I'm going to hold off on new position for a day until better edges avail themselves.

Active Trades Table

| Symbol | Entry Date | Entry Price | Current Pr | % Gain/Lo | Stop | Notes |
|---------------|-------------------|--------------------|-------------------|------------------|-------------|-------------------|
| BA (1/3) | 6/24/2009 | \$43.14 | \$43.00 | -0.32% | | hit intraday stop |
| BA (1/3) | 6/25/2009 | \$41.32 | \$43.00 | 4.07% | | hit intraday stop |
| SPY(s) | 6/25/2009 | \$91.15 | \$91.95 | -0.88% | | |
| SPY(s) | 6/26/2009 | \$92.00 | \$91.86 | 0.15% | | hit intraday stop |
| SPY(s) | 6/29/2009 | \$92.70 | \$91.95 | 0.81% | | |
| DD(s) | 6/30/2009 | \$26.07 | \$25.62 | 1.73% | | |

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